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UNCLAS SECTION 01 OF 09 CARACAS 001416

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TREASURY FOR KLINGENSMITH, NGRANT, AND MMALLOY
COMMERCE FOR 4431/MAC/WH/MCAMERON
ENERGY FOR ALOCKWOOD
NSC FOR DTOMLINSON AND JSHRIER
HQ SOUTHCOM ALSO FOR POLAD

E.O. 12958: N/A

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SUBJECT: MACROECONOMIC UPDATE JULY 2007

REF: A. CARACAS 667

- [1](#)B. CARACAS 741
- [1](#)C. CARACAS 930
- [1](#)D. CARACAS 959
- [1](#)E. CARACAS 994
- [1](#)F. CARACAS 1031
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THIS MESSAGE IS SENSITIVE, BUT UNCLASSIFIED. PLEASE TREAT
ACCORDINGLY.

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OVERVIEW

[1](#)1. Massive government expenditures, excess liquidity, and a
consumption boom have led to high economic growth rates for
the last fourteen consecutive quarters. These same
tendencies have contributed to inflation rates nearing 20
percent a year and inflation shows no sign of declining,
despite the government's efforts. As government accounts
become less transparent and institutions like the Central
Bank and the National Statistics Institute lose autonomy,

figures and methods have become untrustworthy. A weakening investment climate has led to capital outflows in recent years and the overvalued official exchange rate encourages imports and discourages domestic industry. Debt levels are relatively low and the balance of payments and foreign exchange reserves will remain manageable unless oil prices or production fall. Government intervention continues to affect the financial sector and private sector institutions are under threat.

----- ECONOMIC GROWTH -----

12. The Venezuelan economy has grown consistently during the past fourteen consecutive quarters. GDP grew 10.3 percent (in real terms) in both 2005 and 2006 and has grown 8.8 percent thus far in 2007. Non-oil economic activities such as finance (26 percent), communications (18 percent), commerce (21 percent), transportation (16 percent), and construction (27 percent) have grown faster than other sectors. This positive trend has been driven by the huge increase in government expenditures made possible by windfall oil profits. On the other hand, the oil sector has contracted during the past two years (the Central Bank calculates oil sector GDP with constant prices, so changes do not reflect changes in the price of oil). During the first quarter of 2007 oil sector GDP decreased by 5.6 percent. We expect the Venezuelan economy to grow between 6-8 percent in real terms in 2007.

REAL GDP GROWTH RATE (PERCENTAGE) -----

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	OIL	NON-OIL	TOTAL
2000	2.3	4.2	3.7
2001	-0.9	4.0	3.4
2002	-14.2	-6.0	-8.9
2003	-1.9	-7.4	-7.8
2004	13.7	16.1	18.3
2005	2.6	11.1	10.3
2006	-1.9	11.7	10.3
2007			
I Q	-5.6	10.6	8.8

SOURCE: Central Bank of Venezuela.

----- UNEMPLOYMENT -----

13. According to government statistics, the unemployment rate has fallen precipitously in recent years in line with GDP growth. Unemployment figures have been questionable since the National Statistics Institute (INE) changed its (still unpublished) methodology in 2000. Similarly, poverty figures have been unreliable since methodological changes in 2005 and there are concerns that inflation data will be affected by plans to change measurements in the third quarter of 2007. Since 2005, unemployment has reportedly fallen by more than five percentage points, although most attribute this decline to reductions in the labor force, rather than increases in employment (reftel F). The informal sector has also been decreasing in size, amounting to 44 percent of total employees (11.2 million) during May 2007. INE recently announced a new change to its methodology, which will reduce the informal sector to around 34 percent of the labor force. Government social programs (missions) reduce unemployment figures by removing participants from the labor force and estimates are that the missions currently "employ" around five percent of the labor force.

UNEMPLOYMENT (END OF YEAR)

2000	13.2
2001	12.8
2002	16.2
2003	16.8
2004	13.9
2005	11.4
2006	9.5
2007	
JAN	11.1
FEB	10.9
MAR	9.5
APR	8.8
MAY	8.0

SOURCE: National Institute of Statistics (INE).

INTERNATIONAL RESERVES

14. International reserves have decreased by almost USD 12 billion during 2007 because of the USD 6.8 billion transfer of funds from the Central Bank (BCV) to the National Development Fund (FONDEN) in February (USD 2 billion), March (USD 2.5 billion), and April (USD 2.3 billion) of 2007. In addition, PDVSA's USD 7.5 billion bond issuance in April 2007 drew down reserves as PDVSA converted the Bolivars earned from the sale into dollars (reftel A). Increases in imports have also contributed to this decrease as has the decision to maintain PDVSA's dollar earnings in special dollar-denominated treasury accounts. Since its inception in 2005, FONDEN has received upwards of USD 17 billion in transfers from the BCV. The allocations of these funds and their uses are mostly unknown due to the severe lack of transparency regarding FONDEN's activities.

INTERNATIONAL RESERVES (USD MILLIONS)

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	BCV	FIEM	TOTAL
2000 DEC	15,883	4,588	20,471
2001 DEC	12,296	6,227	18,523
2002 DEC	12,003	2,857	14,860
2003 DEC	20,666	700	21,366
2004 DEC	23,498	710	24,208
2005 DEC	29,636	732	30,368
2006 DEC	36,672	768	37,440
2007			
JAN	35,620	772	36,392
FEB	32,569	775	33,344
MAR	31,520	779	32,299
APR	26,393	782	27,175
MAY	24,456	786	25,242
JUN	24,346	789	25,135

SOURCE: Central Bank of Venezuela.

MONEY SUPPLY/M2

15. Money supply growth during the last four years has increased inflationary pressures. In part to reduce excess liquidity, state-owned oil company PDVSA issued bonds worth USD 7.5 billion in April 2007 (reftel A). The issuance didn't have the desired effect on liquidity as banks were able to fund the purchases by redeeming money held in BCV-issued certificates of deposit (reftel B). As such, liquidity was hardly affected. On July 10, 2007, the BCV's

board of directors increased minimum interest rates on savings accounts from 6.5 percent to 8 percent, and raised legal reserve requirements from 15 percent to 17 percent, hoping to reduce liquidity. Most experts do not expect these measures to have a significant effect.

	MONEY SUPPLY/M2 (1)		MONETARY BASE	
	(million Bs.)	Pct.Chg.	(million Bs.)	Pct.Chg.
2000	16,284,578	27.8	5,790,841	17.9
2001	16,976,364	4.2	6,478,295	11.9
2002	19,573,369	15.3	7,701,120	18.9
2003	30,835,975	57.5	11,274,439	46.4
2004	46,363,672	50.4	16,524,461	46.6
2005	70,795,981	52.7	23,086,512	39.7
2006	119,892,075	69.3	44,795,446	94.0
2007 (2)				
JAN	117,532,707	-2.0	43,643,278	-2.6
FEB	118,613,669	0.9	44,101,646	1.1
MAR	121,255,451	2.2	44,974,362	2.0
APR	117,507,673	-3.1	42,953,106	-4.5
MAY	117,875,115	0.3	43,605,464	1.5
JUN	120,910,402	2.6	45,532,879	4.4

(1) M2 includes currency, demand deposits, savings, and certificates of deposit.

(2) Preliminary figures.

SOURCE: Central Bank of Venezuela.

EXCHANGE RATES, BCV LIQUIDATIONS, AND VENEZUELAN BASKET AVERAGE OIL PRICE

16. Foreign exchange controls have been in place since February 2003, and the current fixed exchange rate of 2,150 Bolivars per dollar since March 2005. At the same time, the spread between the official rate and that obtained in the unregulated parallel market has grown from around 20 percent to over 90 percent. According to the Minister of Finance Rodrigo Cabezas, the BRV will not devalue the currency for the foreseeable future. Most economists believe that the BRV will have to devalue when oil prices decline, or when

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expenditures exceed revenues such that devaluation becomes necessary to maintain the public sector. Distortions in the Venezuelan economy continue to increase, and the longer the BRV postpones devaluation, the greater the cost of the adjustment will be for the economy. Daily BCV liquidations so far in 2007 are USD 156 million, as of July 6, 2007. This represents an increase of 48.6 percent over the daily average in 2006.

END OF PERIOD EXCHANGE RATES (Bolivars/USD)
CENTRAL BANK'S LIQUIDATIONS, AND AVERAGE OIL PRICE

	OFFICIAL MARKET	PARALLEL MARKET (1)	DAILY CENTRAL BANK AVERAGE LIQUIDATIONS (USD million)	VENEZUELAN BASKET OIL PRICE (USD/barrel)
2000	699.75			25.91
2001	763.00			20.21
2002	1,401.25			21.95
2003	1,600.00	2,875.00	17.90	25.76
2004	1,920.00	2,673.41	58.40	32.88
2005	2,150.00	2,586.08	78.60	46.03
2006	2,150.00	3,412.46	105.00	56.45

2007				
JAN	2,150.00	4,293.44	160.00	46.83
FEB	2,150.00	3,798.27	189.00	50.41
MAR	2,150.00	3,650.00	124.00	53.03
APR	2,150.00	3,750.00	117.00	58.38
MAY	2,150.00	4,100.00	206.00	59.41
JUN	2,150.00	4,150.00	156.00	62.73

(1) Starting in March 2007, the parallel exchange rate is based on the bond swap selling rate. Before that date, it is the rate obtained using CANTV ADRs.

SOURCES: BCV, CADIVI, Ministry of Energy and Petroleum, and Metroeconomica (private consulting firm).

CONSUMER PRICE INDEX

¶7. The government's inflation target for the year was recently revised from 12 to 14 percent. However, the current yearly inflation rate is almost 20 percent and inflation in Venezuela typically increases over the course of the year. Price controls in force since 2003, a reduction in the value added tax (IVA) from 14 percent to 9 percent, massive importation, and increases in reserve requirements have had limited effects in reducing inflation. The oil bonanza and associated consumption boom continue to offset anti-inflation measures. There are also shortages of basic food items, including milk, meat, beans, sugar, and chicken, as well as construction materials, vehicle parts, and medicines (reftel E).

CONSUMER PRICE INDEX (1997 AVG = 100) and CORE INFLATION

	CPI END OF PERIOD	CPI (% change)	CORE INFLATION (% change)
2000	206.0	13.4	12.8
2001	231.3	12.3	11.3
2002	303.5	31.2	31.2
2003	385.7	27.1	37.9
2004	459.7	19.2	21.1
2005	525.7	14.4	14.6
2006	614.9	17.0	16.3
2007			
JAN	627.2	2.0	1.5
FEB	635.8	1.4	2.9
MAR	631.1	(0.7)	1.1
APR	640.0	1.4	1.2
MAY	651.1	1.7	1.8
JUN	662.6	1.8	1.9

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SOURCE: Central Bank of Venezuela.

BALANCE OF PAYMENTS

¶8. The negative capital account balance is expected to reach a record high in 2007 and international reserves are estimated to fall by as much as USD 10 billion. The public sector increase in foreign assets and the amount of private sector capital flight will exceed the expected positive current account balance (mainly from oil sales). The balance of payments deficit may already be greater than it appears as the official numbers imply oil revenues that far exceed most private estimates of Venezuelan production. If the negative overall balance of payment continues, it will become harder to maintain the current exchange rate (reftel D).

BALANCE OF PAYMENTS SUMMARY
(USD BILLION)

	2005	2006	JAN-MAR 2006	Forecast 2007(1)	Forecast 2007
CURRENT ACCOUNT (A)	25.5	27.2	7.0	3.7	13.0
EXPORTS, FOB	55.5	65.2	15.5	13.7	56.0
IMPORTS, FOB	-23.7	-32.2	-6.2	-9.1	-37.6
TRADE BALANCE	31.8	33.0	9.3	4.6	18.4
NET SERVICES AND RENT	-6.2	- 5.8	-2.3	-0.9	-5.3
NET TRANSFERS	-0.1	-0.1	-0.1	-0.1	-0.1
CAPITAL AND FINANCIAL ACCOUNT (B)	-16.8	-19.5	-5.6	-8.3	-22.6
DIRECT INVESTMENT	1.4	-2.6	-2.0	-1.1	-2.0
PORTFOLIO INVESTMENT	-0.8	-7.6	-0.8	-2.5	-5.6
OTHER INVESTMENT	-17.5	-9.2	-2.8	-4.7	-15.0
NET ERRORS AND OMISSIONS (C)	-3.2	-3.0	-0.4	-1.0	0.0
OVERALL BALANCE (A) (B) (C)	5.5	4.7	1.0	-5.6	-9.6

(1) Preliminary figures.

SOURCES: Central Bank of Venezuela, and Ecoanalitica
(private consulting firm).

MERCHANDISE TRADE BALANCE

19. The overvaluation of the national currency along with liquidity increases has caused huge increases in imports and the reduction of non-oil exports. The United States remains Venezuelan's largest trading partner, representing almost 50 percent of total trade during 2006, followed by Colombia (6.2 percent), and Mexico (4.9 percent). Although the BRV is trying to diversify its trading partners, historical relationships and strong commercial ties make it difficult for the BRV to do so.

MERCHANDISE TRADE BALANCE (USD BILLION)

	2005	2006	JAN-MAR 2006	Forecast 2007(1)	Forecast 2007
OIL EXPORTS (A)	48.1	58.4	13.9	12.1	50.0
NON-OIL EXPORTS (B)	7.4	6.8	1.6	1.6	6.0
TOTAL EXPORTS (C)	55.5	65.2	15.5	13.7	56.0
TOTAL IMPORTS (D)	-23.7	-32.2	-6.2	-9.1	-37.6
MERCHANDISE TRADE BALANCE (C)-(D)	31.8	33.0	9.3	4.6	18.4

(1) Preliminary figures.

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SOURCE: Central Bank of Venezuela, Ecoanalitica, and
Embassy estimates.

FOREIGN DIRECT INVESTMENT

10. Foreign direct investment in Venezuela continues to decrease. The socialist project that the BRV is trying to impose, the announced constitutional changes (reftel G), and the uncertain political and economic future, have restrained investors from making new investments. On the contrary, some foreign companies have decided to sell their assets in Venezuela and to move abroad.

	Abroad	In Venezuela	Net flow
2000	-521	4,701	4,180
2001	-204	3,683	3,479
2002	-1,026	782	-244
2003	-1,318	2,040	722
2004	-619	1,483	864
2005	-1,183	2,583	1,400
2006	-2,089	-543	-2,632
2007 (1)			
I quarter	-795	-260	-1,055

(1) Preliminary figures

Source: Central Bank of Venezuela.

----- CARACAS STOCK EXCHANGE INDEX -----

¶11. The Caracas Stock Exchange has been negatively affected by the nationalization of the largest telecommunications company CANTV and the main electrical utility EDC. Combined, these companies represented around 30 percent of all securities traded on the exchange, and often represented over 50 percent of daily volumes. Continual harassment of the private sector and increased political and economic uncertainty, coupled with nationalizations and presidential announcements such as the plans to withdraw from the IMF have all contributed to the negative behavior of the capitalization index. Venezuelan steel company, Sivensa, now represents almost half of the exchange and what was already a small capital market continues to shrink.

CARACAS STOCK EXCHANGE CAPITALIZATION INDEX (DECEMBER 1993 = 1,000) -----

	2005	2006	2007
JANUARY	29,303.14	25,119.59	43,965.85
FEBRUARY	30,388.61	28,299.33	52,533.71
MARCH	28,977.07	30,882.46	48,945.67
APRIL	25,089.14	31,194.16	43,363.32
MAY	22,493.91	30,270.60	39,481.26
JUNE	21,595.64	30,747.27	40,584.95
JULY	20,561.79	34,230.54	
AUGUST	19,702.21	35,356.57	
SEPTEMBER	20,769.36	35,392.58	
OCTOBER	19,561.74	38,163.31	
NOVEMBER	19,992.69	43,113.17	
DECEMBER	20,394.83	52,233.68	

SOURCES: Caracas Stock Exchange, and Metroeconomica.

----- CENTRAL GOVERNMENT FINANCIAL RESULTS -----

¶12. The BRV has been trying to avoid monetization of extraordinary oil revenues through the creation of two dollar-denominated accounts at the National Treasury Office. The accumulation amounted to over USD 7 billion as of July 12, 2007. The diversion of funds from the Central Bank has

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temporarily decreased petroleum revenues and is in part responsible for the central government's deficit during the first quarter of 2007. These funds are converted to Bolivars at the Central Bank as they are needed by PDVSA to pay expenses. Non-oil revenues represented 57 percent of ordinary spending during January-April 2007. Total central government expenditures grew by 9.2 percent in real terms during the same period.

CENTRAL GOVERNMENT FINANCIAL RESULTS
(USD billion)

	2004	2005	2006	JAN-APR 2006	2007(1)
TOTAL REVENUES	36.1	48.3	62.3	16.2	17.7
Ordinary revenue (A)	24.0	36.2	51.9	14.8	16.4
Petroleum revenue	12.8	19.5	29.4	7.6	6.6
Non-petroleum revenue	11.3	16.7	22.5	7.2	9.8
Extraordinary revenue	12.1	12.1	10.4	1.4	1.3
TOTAL EXPENDITURES	32.6	41.4	58.5	18.4	20.1
Ordinary expenditures (B)	27.2	36.4	53.0	15.7	17.2
Extraordinary expenditures	5.4	5.0	5.5	2.7	2.9
SURPLUS OR DEFICIT (A)-(B)	-3.2	-0.2	-1.1	-0.9	-0.8

(1) Preliminary figures.

Sources: Central Bank of Venezuela.

CENTRAL GOVERNMENT DEBT

¶13. Central government debt levels have been stable during the last four years. Public credit officials at the Ministry of Finance told Econoffs that they will continue to reschedule debt during 2007, buying back the most expensive debt first. At the same time, state-owned oil company PDVSA has been increasing its external debt. Thus far in 2007, PDVSA has issued over USD 12.5 billion in dollar-denominated debt, presumably to continue to finance government social programs and maintain transfers to FONDEN (reftel C).

END OF PERIOD CENTRAL GOVERNMENT DEBT
(USD BILLION)

	2004	2005	2006	Q1 2007 (1)
FOREIGN DEBT	27.2	31.1	27.3	26.5
Bond holders	21.0	25.4	21.5	21.4
Commercial banks	2.0	2.0	1.8	1.7
Bilateral	0.6	0.5	0.5	0.5
Multilateral	3.5	3.1	3.4	2.8
Suppliers	0.1	0.1	0.1	0.1
DOMESTIC DEBT	15.5	15.6	16.8	15.9
TOTAL	42.7	46.7	44.1	42.4

(1) Preliminary figures.

SOURCE: Ministry of Finance.

BANKING SYSTEM

¶15. This is one of the economic sectors that has grown fastest during the last four years. Banks in Venezuela have

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been actively financing the consumption boom. Loans for cars, homes, and credit cards have doubled in less than two years. Financial sector returns exceed 30 percent and

business is booming. In part because of perceived "excess profits," the government has been threatening the financial sector with profit caps and potential nationalization. To date, most of the pressure has been in the form of fixed interest rates, directed lending requirements, and tax increases.

BANKING SYSTEM KEY INDICATORS
(percentages)

	DEC 05	DEC 06	MAR 07
Past due loans/ gross loans	1.08	1.06	1.06
Credit portfolio allowance/ past due loans	251.34	229.09	210.51
Equity/total assets	11.12	9.81	9.41
Net financial margin/ average asset	3.66	2.97	2.40
Net financial margin/ average equity	32.49	31.64	29.09
Net loans/ total deposits	54.86	48.81	50.72

Source: SUDEBAN

INTEREST RATES

¶16. On July 10, 2007, the BCV issued a resolution changing maximum and minimum interest rates for lending (28 percent) and savings (8 percent). Also, certificates of deposit issued by financial institutions now must pay at least 11 percent interest, and the certificates of deposit issued by the BCV will pay 10 percent with a maturity of 28 days, and 11 percent for those maturing in 56 days. By reducing financial margins, bank profits may fall in the short term.

AVERAGE INTEREST RATES OF THE SIX MOST IMPORTANT
COMMERCIAL AND UNIVERSAL BANKS

	Loans	Deposits	
	-----	Savings	90 days
2000	23.91	3.35	14.80
2001	25.64	2.40	14.13
2002	37.08	3.90	28.29
2003	24.05	6.15	17.58
2004	17.06	4.52	12.93
2005	15.36	6.64	11.74
2006	14.64	6.81	10.20
2007			
JAN	15.78	6.58	10.05
FEB	15.50	6.58	10.13
MAR	14.94	6.58	14.94
APR	15.99	6.57	10.11
MAY	15.94	6.57	10.12
JUN	14.91	6.57	10.14

SOURCE: Central Bank of Venezuela.

INTERNET RESOURCES

¶17. INTERNET RESOURCES:

AMEMBASSY CARACAS WEBSITE: venezuela.usembassy.gov

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EXCHANGE RATES AND INTERNATIONAL RESERVES: www.bcv.org.ve
-
STOCK EXCHANGE: www.caracasstock.com
-
TRADE AND LABOR FORCE STATISTICS: www.ine.gov.ve
-
BUSINESS INFORMATION: www.venamcham.org
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INVESTMENT OPPORTUNITIES: www.conapri.org
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www.platino.gov.ve

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